United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

76-7600

To be argued by
CLARENCE FRIED

United States Court of Appeals
FOR THE SECOND CIRCUIT

J. P. FOLEY & COMPANY, INC., JOHN P. FOLEY, JR., ANNE A. FOLEY, and ANITA SALISBURY,

Plaintiffs-Appellants,

against

NEW YORK STOCK EXCHANGE, and AMERICAN STOCK EXCHANGE,

Defendants-Appellees.

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFFS-APPELLANTS

HAWKINS, DELAFIELD & WOOD
Attorneys for Plaintiffs-Appellants
67 Wall Street
New York, New York 10005

CLARENCE FRIED
ROBERT R. MACDONNELL
SAMUEL TURETSKY
JAMES O'CONNOR
Of Counsel

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Statement

This is an appeal from a final judgment entered on December 17, 1976, based upon (1) a jury verdict in favor of appellee New York Stock Exchange; (2) dismissal by the Court of the action against the American Stock Exchange, and (3) dismissal by the Court of appellants' claims against the appellee New York Stock Exchange arising under Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5, 17 C.F.R. § 240.10b-5, §§ 16 and 20 of the Securities Exchange Act of 1934 and common law principles.

Issues Presented

1. Did the District Court (Lasker, J.) properly dismiss appellants' claims against appellees under § 10(b) of the Securities Exchange Act of 1934 (hereinafter the "1934

Act"), Rule 10b-5 and 20 of the 1934 Act at the conclusion of appellants' case?

2. Did the District Court properly charge the jury with respect to appellants' claims arising under Section 6 of the 1934 Act? (Asserted for the purpose of preserving appellants' rights on appeal.)

3. Did the District Court properly deny appellants' motion for judgment N.O.V. with respect to the claims arising under Section 6 of the 1934 Act? (Asserted for the purpose of preserving appellants' right on appeal.)

Nature of Case

Appellants John P. Foley, Jr., his wife, Anne Foley, a business associate, Anita Salisbury, and their corporation, J. P. Foley & Company, Inc. (hereinafter referred to collectively as "the Foleys"), commenced the instant action pursuant to Sections 6, 10(b) and 20 of the Securities Exchange Act of 1934 (the "1934 Act"), and common law principles. (A 8)*

Late in the afternoon of Friday, April 3, 1970, appellants contracted to deliver securities with a then market value of approximately $3,000,000 to Blair & Co., Inc. ("Blair"), a member of the New York Stock Exchange ("the Stock Exchange") and the American Stock Exchange (the "Amex"). (A 153) Without appellants' knowledge on the same day appellants contracted to deliver their securities to Blair, the Stock Exchange directed liquidation of all of Blair's insider subordinated securities. (A 739-40) Within two months thereafter, and still without knowledge of the direction of the liquidation of the subordinated accounts, appellants transferred all of their securities to Blair. (A 224)

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* Numbers in parentheses prefaced by A refer to the Joint Appendix, by R refer to the Record on Appeal and by PX or DX refer to plaintiffs' or defendants' Exhibit at trial, and E refer to Exhibit Volume.

Plaintiffs commenced the negotiations which led to the April 3rd closing with Blair in February, 1970. (A 145) It is urged that the evidence established that throughout this entire period, the Stock Exchange, with the knowing acquiescense of the Amex, directed not only the day to day operation of Blair, but also directed the solicitation of appellants' loan to Blair. (A 721-22) The evidence demonstrated that the Stock Exchange directed the solicitation of the plaintiffs' capital either to protect its own members or to reduce the exposure of its Special Trust Fund which had been created by Blair's severe operational and financial condition. (A 494-96; 721-22; 741-42; 765; PX 64, E 336)

In dismissing appellants' claims, the District Court stated:

> "My rational is that in the first instance the Exchange owned no direct duty, as I see it, to Mr. Foley and could be held liable, if at all, only as an aider and abettor. But I don't believe that it is desirable or necessary to press the distinction because, whether as a principal or as an aider and abettor, it seems to me that the proof is totally inadequate to establish the requisite element of scienter as defined by the Court in Hochfelder.
>
> There is absolutely no showing in the case that the Exchange intended to manipulate the situation in any way, as stressed in Hochfelder. There is not even, in my opinion, evidence which would establish the kind of recklessness which the Court implies, without deciding, in a footnote might possibly support a case under 10b-5.
>
> Instead of finding that the Exchange was chargeable with total inaction, it seems to me that although *I do believe that their behavior, in the light of hindsight, could have been keyed up*, nevertheless it seems to me that they kept on top of the situation in good faith.

> They did not fail to disclose to Mr. Foley anything whatsoever, because they made no disclosure to him. They had every right to assume that the firm itself would have disclosed to him all business facts normal to such a transaction and had even more right, it seems to me, to assume that Mr. Foley himself, in making so large an investment as $2.5 million in a firm which he admits he knew was having business troubles, when every person reading the newspapers and paying any attention to the affairs of the Stock Exchange at that time knew that there were serious problems facing Stock Exchange firms, would have asked for. The necessary information." (emphasis added) (A 1007-08)

It is respectfully submitted that the court's rationale clearly indicates its error in dismissing the complaint. Not only did the district court misread the *Hochfelder* decision, but it finally resolved such contested issues of fact as scienter, and the assumed knowledge of appellants relating to the disclosure of misleading information or lack thereof. Finally, the court below ignored the fact that a failure to disclose (omission) can support a cause of action for violation of the federal securities law.

Facts

a) The Blair-Schwabacher Merger and the Conversion of the Midwest System

Until late 1968, Blair had been in an apparently stable financial condition. (A 372) At the same time, Schwabacher & Company, a west-coast brokerage firm, had been experiencing serious operational and financial problems. (A 374-75) In order to prevent the collapse of the Schwabacher firm, the Stock Exchange strongly urged and then

sanctioned the merger of Blair and Schwabacher. (A 314; 374)*

Subsequent to the merger, the Stock Exchange, together with Blair's auditor, Arthur Young & Company,** directed Blair's conversion of its books and records from the semi-computerized automatic computer system ("ACS") to the fully computerized Midwest Stock Exchange Corp. System (the "Midwest System"), despite the objection of Blair's key personnel (R 679) and the fact that the Stock Exchange knew that Blair was not in sufficiently good operational condition to convert to the Midwest System.***

b) The "Surprise Audit"

After the merger, with the approval of the Stock Exchange and pursuant to its rules, Arthur Young commenced an "annual surprise audit" of Blair in September, 1969. (PX 19B-2, E 112) In a marked departure from the practices and rules of the Stock Exchange, the Exchange permitted Arthur Young to conduct a "split audit"—which

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* The Stock Exchange, of course, sought to prevent the liquidation of the ailing Schwabacher, even if it meant wedding it to a healthy firm. The liquidation of the Schwabacher firm would have created a substantial exposure to the Stock Exchange's Special Trust Fund. (A 313-314; 374-76)

** Arthur Young was also auditor for the Midwest System.

*** For example, by April 16, 1969, the Stock Exchange was aware that Blair was "short" $256,470 in cash dividends and $1,613,275 in security dividends and had unlocated security differences of $858,926 (which had not been charged to net capital). (PX 32A) By June, 1969, the Stock Exchange itself had determined that Blair's operations on the ACS had resulted in $5,-200,000 in missing securities and $9,600,000 securities on hand whose ownership could not be determined. (PX 44, E 223) The Stock Exchange's reaction was to "abandon" the matter and start a fresh securities count. On July 3, 1969, the Stock Exchange concluded that Blair was in violation of Rule 325, but advised Blair that it "has determined not to pursue the matter further at this time." (PX 32, E 187)

allowed separate treatment of the books and records of the two divisions of Blair no matter what consolidation would show—of the Schwabacher and Blair Divisions of Blair for the reason that:

> "5. The A.Y. [Arthur Young] staff did consider the practicality of combining the audit of Blair & Co. and Schwabacher in June. In the best judgment of the partners of A.Y., the highly questionable condition of the records at Schwabacher could conceivably result in an unsatisfactory report for the entire firm." (PX 19B-2, E 112)*

Fully aware that the "surprise audit" of Blair was to commence in September, 1969, and that Blair was experiencing severe capital problems, Blair Chairman Vanderbilt convinced fellow subordinated lender and director Melville Ireland to put $2,000,000 of Ireland's own capital into Blair "on a ninety-day basis" (the anticipated time of the audit). (A 888-92) The aforesaid loan was treated by Blair as subordinated capital and thus served to disguise Blair's net capital deficit.

The infusion of Ireland's money at this time had a triple negative and misleading effect. First, it gave Blair the ostensible appearance of complying with the Stock Exchange's net capital rule. Secondly, by creating the appearance of compliance with the Stock Exchange's net capital rule, it allowed Chairman Vanderbilt to withdraw his own subordinated loan of $1.7 million in January, 1970, (with the knowledge of the Stock Exchange).* (PX 19M, E 176) Thirdly, it negated the withdrawal provision of the Foley agreement which had been based upon the assumption that Blair's capital was, in fact, properly subordinated.

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* Apparently the Stock Exchange was more concerned with the possibility of an unsatisfactory report than an accurate one.

c) The Results of the "Surprise Audit"

On December 8, 1969, after several extensions of time to complete the "surprise audit" totalling approximately 45 days, Young prepared Blair's Answers to Financial Questionnaire (the "Answers") for submission to the Stock Exchange and Blair's Directors. Together with the Answers, there was filed a document entitled "Certified Public Accountants' Supplementary Report" or "the material inadequacies letter"* which stated, in part:

> "Based on our examination described above, we found certain inadequacies in the accounting system, the internal accounting control and procedures for safeguarding securities which, in our opinion, were material in the circumstances." (PX 19-E, E 155).

The Answers and material inadequacies letter were not only reviewed and approved by Stock Exchange officers but also by its Examiners Division, which had a duty to review financial questionnaire answers submitted by firms like Blair.

Question 13 of the Answers described "Other Security Positions $2,404,732 long" and "Other Security Positions $2,420,974 short". (E 166) The "long" security positions referred to $2,404,732 worth of securities on hand at Blair whose ownership could not be determined. (E 166) The "short" security positions referred to $2,420,974 worth of securities for which Blair was accountable but which were missing. There is no question that the missing securities problem was of material importance.** Vanderbilt confirmed the problem was so significant (i) that the entire

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* This is a confidential document filed with the Exchange and SEC.

** The fact that the short and long positions had a small difference cannot be considered insignificant. Both the longs and shorts represented liabilities of Blair and were not offsetting.

back office was trying to locate the securities (A 367) and (ii) that the problem affected Blair's viability as a going entity. (A 367-68) Stock Exchange Senior Coordinator John J. Deignan indicated that the security differences were "substantial or material in amount." (A 684-85)

d) The Statement of Financial Condition

After the filing of the Answers, the Stock Exchange directed that Blair prepare for certification, under the name of Arthur Young, a Statement of Financial Condition. (PX 2, E 2) Pursuant to Rule 419 of the Stock Exchange:

> "The financial statement based on the audited answers to the financial questionnaire shall be one which is prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding audited statement, and shall include, in the basic statement or accompanying footnotes, *all informative disclosures necessary to make the statement a clear expression of the organization's financial condition and must be accompanied by independent public accountants' report expressing an opinion on such statement.*" (emphasis added)

The Blair statement was jointly prepared by Blair Controller James J. Rush, Arthur Young and Stock Exchange Chief Examiner Maurice Minon (PX 19K; 19L, E 174-75) six weeks after the filing of Blair's Answers. In fact, prior to its release, the Financial Statement was submitted to the Stock Exchange for review, discussed by the Stock Exchange with representatives of Arthur Young and approved for distribution. (PX 19K; 19L) The Financial Statement was materially misleading and failed to contain a clear expression of Blair's financial condition in many respects including the fact that no mention was made of Blair's back office problem, no mention was made

of the missing securities and no reference was made to the material inadequacies letter.* (A 332-33) All of the above facts were known by the Stock Exchange prior to its approval of the Financial Statement.

e) Other Reports Required to be Filed

As a further indication of the Stock Exchange's complicity in the continuing deterioration of Blair's financial condition, in the summer of 1969 the Stock Exchange directed Blair to file weekly financial reports. (E 223-24) These reports were lost by the Exchange and unavailable at the trial. The Exchange also directed Blair to file monthly reports. The testimony established that despite this direction, the Exchange permitted Blair to file the reports for January, February and March 1970 in late April, subsequent to the Foley closing. (A 680-81) The requirement for the filing of these reports indicated a serious situation and was an unusual practice. (A 691-92)

f) The Crystallization of Blair's Problems

On January 15, 1970, prior to distribution of the Financial Statement, Blair's officers and directors met to discuss the very serious problems surrounding the financial condition of Blair.** (A 449-51) Immediately following this meeting, Ramsey and Vanderbilt reported to the Stock Exchange concerning the condition of Blair. (A 446-62)

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* The matters set forth in the material inadequacies letter caused Vanderbilt "to question the financial condition of Blair." (A 328) Vanderbilt testified, however, that the Financial Statement shown to Foley contained nothing which would have indicated the problems. (A 332-33)

** The books and records were so out of control that Blair's capital position could not be determined with any degree of reliability. (A 387-88; 446-62; 480-82)

Specifically, Ramsey requested that the Stock Exchange become a daily or integral part of Blair's operations because the firm had lost money, the directors felt that Blair was out of control and they could not determine Blair's net capital position.* (A 446-54; 459-62; 480-82) The same facts were reported to Amex President Ralph Saul and other top Amex officials. (A 379-81; 478) In many meetings thereafter with the Stock Exchange, Blair officials continually reported on its worsening financial condition. Instead of taking steps to correct the situation by directing a full disclosure and revision of the Financial Statement, the Stock Exchange, serving the interests of its members, the financial world and its own Special Trust Fund, ignored the public by covering up Blair's condititon and by directing, aiding and abetting Blair to raise additional capital.

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* Ramsey testified as follows:

"Q. Mr. Ramsey, did you state in that deposition, 'On January 16th I went to the New York Stock Exchange'?

"A. Yes, I did.

* * *

"Q. Are you able now to state the substance of the conversation you had with Mr. Arning in person on January 16th, Mr. Ramsey?

"A. The substance of it was bringing him up to date on what had gone on on the computer breakdowns, on the situation as far as I was concerned about whether or not the capital situation was in or out of control, about the situation as I knew it concerning Blair at that time.

"Q. Did you talk about whether or not you were possibly in violation of Rule 325?

"A. Yes.

"Q. What did you tell him about that?

"A. That we may well be in violation of 325 because I had no idea whether we were over or under capitalization at that point in time. I used the expression *it could have been $10 million either way*." (A 460-461) (emphasis added)

g) The Stock Exchange Demand For Additional Capital And The Protection Of The Special Trust Fund, Exchange Members And The Financial Community

It is clear why the Stock Exchange directed Blair to obtain appellants' money even though the company was out of control and the Exchange knew that Blair was not in compliance with its net capital rule. Any influx of new capital would, necessarily, lessen the potential exposure to the Exchange's Special Trust Fund which had been established to reimburse customers for losses sustained as a result of a member firm's operations. (A 494-96; 765) In addition, new capital would protect members of the Exchange and create the appearance of financial community stability. Thus, to protect its own selfish interests, the Stock Exchange kept its eye on the negotiations with appellants. (A 705-07; 721-42; PX's 62, 62A, 63, 64, E 333-36) In fact the Stock Exchange auditors were on Blair's premises on a daily basis (A 757-58; 780-82; 1188-91) and engaged in a "cover-up" by permitting dissemination of misleading financial information.

The extent of the Stock Exchange's involvement in Blair, as appears from a discussion of all the facts and circumstances, demonstrates its leadership and control over Blair and its participation in the fraud perpetrated against appellants or, at a minimum, that it aided and abetted Blair in violating Section 10(b) and Rule 10-b(5) in the transactions with appellants.

h) The Stock Letter and Ireland's Second Infusion of Capital

When Blair was unable, internally, to comply with the Stock Exchange direction to obtain more capital, the Stock Exchange, to place itself on record, by letter dated February 19, 1970, advised Blair:

> "We must insist that immediate action be taken to improve the capital of Blair & Co., Inc. to the point

> where it meets Exchange requirements. Unless this is accomplished by the close of business on February 25, 1970, we will have no alternative but to impose restrictions designed to curb the volume of the Blair & Co., Inc. business until such time as the capital requirements of the Exchange are met satisfactorily."* (PX 19-H, E 171)

At this time, the Stock Exchange knew that Blair's books and records were out of control, and contained figures which were totally lacking in credibility, but nevertheless permitted plaintiffs to negotiate their loan transactions with Blair on the basis of a financially distorted picture of Blair. (A 706-07) With the approval of the Stock Exchange, Blair Director Ireland lent Blair $2,000,000 on a sixty-day "stopgap" basis (A 700-03), with the stipulation that Ireland would withdraw the proceeds of the loan upon the conclusion of the Foley/Blair subordination. (A 700-03; 932-42; PX 59, E 328) By this sophisticated and clandestine device, the Stock Exchange afforded itself the excuse for delaying liquidation of the subordinated account until the Foley investment was consummated.

i) The $3,000,000 Fraud Perpetrated Upon Plaintiffs

Both Blair and the Stock Exchange knew that the purpose of the Foley subordination was to cure any possible net capital deficiency in Blair. (A 387-88) Indeed, the Foley loan agreement, which had been reviewed and approved by the Stock Exchange (A 705-07; 721-42), contained a warranty to that effect (E 70).** However, while the Stock Exchange approved the agreement, neither it nor Blair knew what the net capital deficiency was or

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* Obviously the Stock Exchange knew full well at this time that Blair was not in compliance with Rule 325, the net capital rule.

** Dr. Foley testified that he was told that his investment would put Blair in compliance with the net capital rule.

even if there was one (A 387-88; 457-65).* Even though the Stock Exchange knew that there were no reliable figures available for Blair and that any documentation given to Foley, including the Statement of Financial Condition, which the Stock Exchange had approved for dissemination to the public, could not have accurately reflected the financial condition of Blair, it failed to advise plaintiffs of any of the problems relating to Blair.

The Stock Exchange's participation is established by their own admission that during the Foley/Blair closing, Stock Exchange Senior Coordinator Deignan conferred by telephone with Joseph Daley, Esq., Blair's attorney at the closing, and acknowledged that Blair would not meet the Exchange capital requirement (A 730-31; PX 64, E 336). Thus, although the Stock Exchange knew that Blair's position was impossible, that despite the introduction of plaintiff's capital, Blair would still not be in compliance with the Exchange's net capital rule and that any financial figures given to plaintiff had, of necessity, to be misleading and incomplete, the Stock Exchange allowed Blair to complete the closing and thereby comply with the Stock Exchange direction to bring in more capital—"as much as you can get." (A 721-22).

On Monday, April 6, 1970, the first business day following the loan closing, the Stock Exchange, in accordance with its previous determination, mandated liquidation of all of Blair's insider subordinated securities. (A 351; 739-40) The liquidation, as such, was a matter of serious general concern (A 340, 350). For appellants in particular, they would not have entered into the agreement had they known that the liquidation had been ordered. Moreover, the liquidation nullified the withdrawal provision of

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* This problem is highlighted by the fact that the Stock Exchange and Blair often came up with differences in the capital computations (PX 60-61, E 331-32) and whatever figures existed were "meaningless" (PX 59A, E 329).

their subordination agreement, which had been approved by the Stock Exchange (see "A Case for Arbitration", *J. P. Foley & Co., Inc.* v. *Blair & Co., Inc.*, N.Y.S.E. August 12, 1970). (DX K, E 373) Thus, it is submitted that the concerted plan to obtain capital had run full cycle, aided and abetted by the direction, control and actual participation of the Stock Exchange. Appellants did not even get a one day run for their money.*

j) Subsequent Developments

Although attempts were made to salvage Blair through a merger sabotaged by the Stock Exchange, it was subsequently liquidated under the direction of a Stock Exchange appointed and controlled liquidator. (A 739-40) The books and records of Blair were closeted away in a warehouse, beyond the eye of judicial scrutiny. Appellants' loss was a total one.

POINT I

The District Court improperly dismissed appellants' claims under the federal securities laws.

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), makes it unlawful for any person to employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security in contravention of the Rules and Regulations of the Securities and Exchange Commission (hereinafter the "Commission"). The Commission has enacted Rule 10b-5, 17 C.F.R. § 240.10b-5 (hereinafter "Rule 10b-5") pursuant to the 1934 Act, which Rule provides as follows:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or any instrumentality

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* Stock Exchange Coordinator Deignan testified that he was unable to explain why the Stock Exchange permitted the closing to take place "in view of Blair's condition." (A 741-42)

of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit any person."

in connection with the purchase or sale of any security.

Elements of a 10(b)-5 Cause of Action

In order to impose liability under Section 10(b) and Rule 10b-5 for a misstatement or omission, the misstatement or omission, as in the instant case, must have occurred in connection with the purchase or sale of a security. It is clear that an investment in a brokerage firm via a subordinated loan constitutes a purchase or sale of a security within the meaning of the 1934 Act. For example, in *New York Stock Exchange* v. *Sloan*, 394 F.Supp. 1303, 1311 (S.D.N.Y. 1975) the court held:

> "We agree with the court in *Hughes* v. *Dempsey-Tegeler, Inc., supra,* that, at least for purposes of the present motion, subordinated lenders are investors' in Orvis. The definition of a security as set forth in § 2(1) of the Securities Act of 1933 (15 U.S.C. § 77b(1) and § 3(a)(10) of the Exchange Act of 1934 (15 U.S.C. § 78c(a)(10) includes 'any . . . investment contract.' The Supreme Court has defined such contracts as any 'contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the pro-

motion of a third party.' *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 298-299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946). A subordinated agreement meets this test because it subjects the securities of the lender to the claims of creditors in exchange for the payment of interest by the borrower; and the continuing paying of interest to him depends wholly on the efforts of the borrower, in this case, Orvis.

See, also, *Weinberger* v. *New York Stock Exchange*, 335 F.Supp. 139, 146 (S.D.N.Y. 1971); *Weinberger* v. *New York Stock Exchange*, Current Fed. Sec. L. Rep. ¶ 95,348 (S.D.N.Y. Nov. 6, 1975); *Aixala* v. *W. E. Hutton*, 1974-1975 Fed. Sec. L. Rep. ¶ 94,981 (S.D.N.Y. Feb 10, 1975); and *Hughes* v. *Dempsey-Tegeler, Inc.*, 1973 CCH Fed. Sec. L. Rep. 94, 133 (C.D. Calif. 1973).

In addition to the representation having been made "in connection with" a purchase or sale of securities, a plaintiff in a 10(b)-5 suit must also establish a material misrepresentation, relied upon to the detriment of plaintiff. It is evident from a review of the decision below granting appellees' motion for dismissal that the Court was satisfied that appellants had sustained their burden of proof with respect to all of the elements of their securities claim except for culpability or "scienter." Clearly, appellants had established that the omissions and errors in the Financial Statements of Blair were material, *i.e.*, such that a reasonable person would have attached importance to the information in determining a course of action. *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2nd Cir. 1970). It was equally clear that the evidence had established causation in fact between appellees' misrepresentations and appellants' damage. Appellants established that they had relied upon appellees' misrepresentations to their detriment in the amount of $3,000,000. *Herzfeld* v. *Laventhol, Krekstein, Horwarth & Horwarth*, 378 F.Supp. 112 (S.D.N.Y. 1974), *aff'd*, 540 F.2d 27 (2nd Cir. 1976).

There can be little doubt that appellants also established that appellees' inaction, their failure to disclose and participation in the scheme of Blair, its officers and directors constituted material misrepresentations within the meaning of the securities laws. Where the financial statement of Blair was inaccurate within the understanding of the average, prudent investor, materiality was established. *Chris-Craft Indus., Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2nd Cir.), *cert. denied,* 414 U.S. 910 (1973); *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2nd Cir. 1965), *cert. denied,* 382 U.S. 811 (1965).

Thus, the central issue on this appeal is whether the District Court properly held th t appellants had failed to prove cupability or "scienter" a a matter of law. It is respectfully submitted that analysis of the relevant decisions indicates that the District Court should have submitted the question of appellees' culpability to the jury.

The District Court held that appellants' proof was "totally inadequate to establish the requisite element of scienter as defined by the Court in *Hochfelder*" (*Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976)). Judge Lasker stated that there was ". . . no showing . . . that the Exchange intended to manipulate the situation in any way, as stressed in *Hochfelder.*" In so holding, it is respectfully urged that Judge Lasker has misapplied the rationale of *Hochfelder.*

In *Hochfelder,* the Supreme Court was concerned with the general question of whether negligence was sufficient to satisfy the culpability requirements of 10b-5. The Court did not redefine intent or discuss the different elements of proof necessary to establish "scienter". Thus, it is respectfully submitted that the Supreme Court in *Hochfelder* did not intend a radical, if any, departure from the acceptable principles previously established by the Courts in defining "scienter". *McLean* v. *Alexander,* CCH Current Fed. Sec. L. Rep. ¶ 95,725 (D. Del. 1976); *see, Louis Haimoff, Holmes Looks at Hochfelder and 10b-5,*

Bus. Law, Nov. 1976, p. 147. Rather, the Court reaffirmed that 10(b) ". . . was intended to proscribe knowing misconduct," the traditional common law fraud test that a plaintiff must prove either a knowingly false statement or that a defendant was aware of facts which would have made clear the probability of falsehood. *Lanza* v. *Drexel & Co.*, 479 F. 2d 1277 (2nd Cir. 1973). Had the District Court analyzed the relevant decisions in this Circuit and applied their rationale to the facts proved by appellants, it is urged that the question of appellees' responsibility under 10(b) should have been submitted to the jury.

A. Criteria for Granting Dismissal

In *Brady* v. *Southern Railway Co.*, 320 U.S. 476 (1943), the Supreme Court stated:

> "When the evidence is such that without weighing the credibility of the witnesses there can be but one reasonable conclusion as to the verdict, the Court should determine the proceeding by non-suit, directed verdict or otherwise in accordance with the applicable practice without submission to the jury, or by judgment notwithstanding the verdict. By such direction of the trial the result is saved from the mischance of speculation over legally unfounded claims." 320 U.S. at 479-480.

The criteria established by the Supreme Court has been adopted and expanded in this Circuit. For example, in *Armstrong* v. *Commerce Tankers Corp.*, 423 F.2d 957 (2nd Cir. 1970), *cert. den.*, 400 U.S. 833 (1970), the Court held:

> "Whether the motion is one to direct a verdict or to set aside a verdict which the jury has returned, the test applied by the court is the same. The evidence must be viewed in the light most favorable to the party other than the movant. The motion will be granted only if (1) there is a complete absence of

probative evidence to support a verdict for the non-movant or (2) the evidence is so strongly and overwhelmingly in favor of the movant that reasonable and fact minded men in the exercise of important judgment could not arrive at a verdict against him." 423 F.2d at 959.

See, also, *Diapulse Corp. of Amer.* v. *Birtcher Corp.*, 362 F.2d 736, cert. dismissed, 385 U.S. 801 (1966); *Bigelow* v. *Agway, Inc.*, 506 F.2d 551 (2nd Cir. 1974); *Noonan* v. *Midland Capital Corporation*, 453 F.2d 459 (2nd Cir. 1972).

In *O'Connor* v. *Penna. R.R.*, 308 F.2d 911 (2nd Cir. 1962), the Court stated:

> "The case is withdrawn from them [the jury] 'as a matter of law' because no jury could reasonably bring in a verdict for the opponent of the moving party. To decide upon the propriety of granting this motion, the court looks to the substantial evidence tending to bolster the case of the non-moving party and draws all reasonable inferences therefrom." 308 F.2d at 914-15.

Thus, viewing the evidence most favorable to appellants, it cannot be said that reasonable men could not have found a verdict for appellants. It is respectfully submitted that the facts proved at the trial established a prima facie case of "scienter".

B. Appellees' 10(b) Liability

The scope of liability under Rule 10b-5 was dealt with in *Ernst & Ernst* v. *Hochfelder*, *supra*. In that case the Supreme Court held:

> "We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 *in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud.* 421 U.S. 909 (1975). We conclude that

it will not and therefore we reverse." (emphasis added)

Since appellants have demonstrated "scienter", it is urged that they have complied with *Hochfelder* which is, in any case, compatible with *Lanza* v. *Drexel & Co., supra.* Indeed while the Supreme Court did not specifically define scienter—intent to deceive, manipulate or defraud—it did state in footnote 12 what this Court had already held, namely that "scienter" was required to be proved to establish a 10b-5 case and could be established by intent to defraud, reckless disregard of the truth or knowing use of some practice to defraud.

In *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), this Court stated:

> "[W]e believe that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5." 479 F.2d at 1306.

and went on to state in a footnote to the above quoted passage:

> "In determining what [sic] constitutes 'willful or reckless disregard for the truth' the inquiry normally will be to determine whether defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort. *Chris-Craft Indus., Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 363, 364, 396 through 399 (2d Cir. 1973). . . ." 479 F.2d at 1306.

In the case at bar, the nature of the non-disclosure and misrepresentation in the Statement of Financial Condition are of such magnitude as to make one wonder whether the true purpose of the Statement was to inform the public or to create a false impression of Blair's viability as a going

concern. It certainly was not "a clear expression of the organizations's financial condition" as mandated by Stock Exchange Rule 419.

It is equally clear that the Stock Exchange knew that there had been a failure to disclose material facts. It was the Stock Exchange which approved dissemination of the false and misleading financial statement at a time that it was intent upon forcing Blair to obtain additional capital and thusly reduce exposure to its Special Trust Fund. .It even facilitated this plan and scheme by permitting Blair director Ireland to contribute $2,000,000 as a "stopgap" while Blair was negotiating with appellants.

In *Herzfield* v. *Laventhol, Krekstein, Horwarth & Horwarth, supra,* United States District Judge McMahon, stressing the accountants' access to information not available to the investing public, held accountants liable for their failure to disclose their knowledge of the uncertainty of the subject company's ability to collect the balance due on a vital contract and for the nondisclosure of the facts which made collection uncertain. Accordingly, the court held that the scienter requirement had been satisfied because the accountants either ". . . had actual knowledge of any misrepresentations or omissions" or they had failed ". . . to discover the misrepresentations."

The error of the court below is found in its failure to define the parameters of proof necessary to establish "scienter" and the application of the rules of law relevant thereto.

In *Republic Technology Fund, Inc.* v. *Lionel Corporation,* 483 F.2d 540 (2nd Cir. 1973), this Court stated:

> "The test to be applied is clear in terms if not in application . . . [S]omething short of specific intent to defraud is required and something more than 'mere negligence'. Certainly knowledge of the fact that the figures created a false picture is enough . . ." 483 F.2d at 551.

Thus, knowledge of the falsehood of financial documentation and the fact that the documentation created a false impression relating to the stability of a company is one element that may establish "scienter". In the instant case, appellants established:

1) that the Stock Exchange directed Arthur Young to conduct the audit of Blair; (PX 19-B2, E 112)

2) that the Stock Exchange was in constant contact with the officers and directors of Blair and was kept fully advised of Blair's capital position; (A 454-56; 757-58; 1188-91)

3) that the Stock Exchange received, reviewed and approved the Financial Statement for publication, (PX 19K; 19L, E 174-75) it knew at that time that the Statement was misleading, at least to the extent that it failed to make reference to missing securities, it failed to indicate the serious back office problems then being experienced by Blair, and it failed to refer to the substantial losses Blair had incurred subsequent to September, 1969. (A 332-333)

4) that the Stock Exchange placed its own auditors in Blair to keep itself apprised of the financial condition of Blair; (A 480-82)

5) that the Stock Exchange received, reviewed and approved appellants' subordination agreement; (A 721-42; PX's 62; 62A; E 333-35)

6) that the Stock Exchange knew, and so advised Blair, but not appellants, on the date of appellants' closing with Blair, that appellants' subordination would not bring Blair into compliance with the Exchange's net capital rule and that the insider subordinated security positions would be liquidated commencing the next business day after the closing. (PX 64, E 336)

It is respectfully submitted that appellants clearly demonstrated that the Exchange possessed sufficient knowledge of the misstatements and omissions relating to the Blair Financial Statement such that the "scienter" requirement was satisfied. *See,* also, *Globus* v. *Law Research Service, Inc.,* 418 F.2d 1276 (2nd Cir. 1969), *cert. denied,* 397 U.S. 913 (1970); *Astor* v. *Texas Gulf Sulphur Co.,* 306 F.Supp. 1333 (S.D.N.Y. 1969).

In *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21 (S.D.N.Y. 1963), an individual defendant had obtained shares of a corporation for little or no consideration. The stock was then resold to the public through the American Stock Exchange without the required registration statement and on the basis of fraudulent misstatements of the individual defendant concerning the consideration paid for the shares.

The American Stock Exchange moved to dismiss plaintiff's complaint for failure to state a cause of action. With respect to plaintiff's fraud claims, the Court held:

> "In addition to a general allegation of conspiracy among all defendants, the trustees claim that the defendant Exchange and its officers aided, abetted, and assisted the illegal distribution of Swan-Finch stock by failing to take necessary disciplinary action against abusive conduct and practices of which they knew or should have known.
>
> Since knowing assistance of or participation in a fraudulent scheme under Section 10(b) gives rise to liability equal to that of the perpetrators themselves, the facts alleged by the trustees, if proven, would permit recovery under Section 10(b). 217 F. Supp. at 28.

See, also, *Fischer* v. *Kletz,* 266 F. Supp. 180 (S.D.N.Y. 1967).

Where, as here, the Exchanges did more than possess knowledge but actually participated in the devices and

methods by which appellants were defrauded, it is submitted that the issue of appellees' responsibility under the federal securities laws should have been submitted to the jury. *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (1973); *Fischer* v. *New York Stock Exchange*, 408 F. Supp. 745 (S.D.N.Y. 1976) (where the court found a duty to disclose even absent participation); *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. den.*, 397 U.S. 989 (1970); *Rochez Bros. Inc.* v. *Rhoades*, 527 F.2d 880 (3rd Cir. 1975).

In *Brennan* v. *Midwestern United Life Ins. Co., supra*, the Court concluded that defendant Midwestern had substantially assisted and encouraged a brokerage firm's violation of Rule 10b-5. In so holding, the Court relied upon evidence of the following:

> 1) the officers of Midwestern knew that false misrepresentations had been made by agents of the brokerage firm; knew that the firm was improperly using certain monies as working capital and knew that the conduct of the firm was improper;
>
> 2) Midwestern had actually threatened to report the brokerage firm to the appropriate securities agent;
>
> 3) Midwestern stood to benefit from the deception; and
>
> 4) the officers of Midwestern knew that by failing to report the brokerage firm they were actually encouraging the firm to continue the deceptive practices.

In affirming the district court decision, the Court of Appeals for the Seventh Circuit stated:

> ". . . that the district court was correct in concluding that Midwestern's acquiescence through silence in the fraudulent conduct . . . combined with

its affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and Rule 10b-5." 417 F.2d at 154-155.*

It is urged that *Brennan* is not dissimilar to the instant case and that its rationale should control. In the instant case:

1.(a) The Stock Exchange knew that the Financial Statement of Blair contained material inadequacies but yet approved distribution of same to shareholders, investors, subordinated lenders (appellants) and the general public;

(b) The Stock Exchange knew that the books and records of Blair were out of control and that it was impossible to calculate whether Blair was in compliance with the Exchange's net capital rule;

(c) The Exchange, by reason of the fact that it had reviewed and approved appellants' subordination agreement, knew that appellants believed that their contribution would place Blair in compliance with the Exchange's net capital rule, thus eliminating the necessity for the liquidation of the insiders' subordinated securities.

(d) The Exchange knew that appellants' subordinated loan would not place Blair in compliance with its net capital requirement and advised Blair, but not appellants, of said fact while the closing was in progress.

2. The Stock Exchange had, on numerous occasions, threatened to take action and enforce its Rules & Regulations against Blair but did not act until after appellants had contributed their $3,000,000 to Blair.

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* Here, participation was found by reason of Midwestern's failure to report the firm after threat to do so, thereby allowing the firm to cover up its transgressions and continue same without fear of disclosure.

3. The Exchange, and in particular, its Special Trust Fund, benefited from the input of appellants' money by reduction of the exposure of the Fund to customers and creditors;

4. The conspiracy of silence and inability (or worse) of the Exchange to respond to the financial problems of Blair and the failure of the Exchange to follow up on its threats to Blair to enforce its net capital rule and restrict Blair's trading provided Blair with an unrestricted "license to steal" from appellants.

Viewed as above, it is appellants' position that the above evidence and the natural inferences to be drawn thereof raise questions of fact with respect to appellees' responsibilities under the federal securities laws which should have been submitted to the jury for determination.

POINT II

The Stock Exchange and Amex acted as controlling persons within the meaning of the federal securities laws.

Under the provisions of both the Securities Act and the Exchange Act, a "controlling person" may be vicariously liable for a violation of the federal securities laws. Thus, pursuant to Section 16 of the Securities Act:

> "[e]very person who . . . controls any person liable under Sections 11 or 12 shall also be liable jointly and severally with and to the same extent as such controlled person . . ., unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist."

Similarly, under Section 20(a) of the Exchange Act:

> "Every person who, directly or indirectly controls any person liable under any provision of this title or

> of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person . . ., unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

The nature of "control", as defined in both these sections "has been interpreted as requiring only some indirect means of discipline or influence short of actual direction . . . ." *Myzel* v. *Fields,* 386 F.2d 718, 738 (8th Cir. 1967), cert. den. 390 U.S. 951 (1968). See *Strong* v. *France,* 474 F.2d 747 (9th Cir. 1973).

The position of both the NYSE and the Amex *vis-a-vis* Blair far exceeded this minimum requirement. Under Section 6 of the 1934 Act, the Stock Exchange and the Amex had the power and duty to enforce compliance by Blair with the provisions of federal securities laws. The Stock Exchange "strongly encouraged" the Blair-Schwabacher merger, directed Blair to convert to the Midwest System, caused Blair to furnish regular reports, instructed Blair to solicit additional capital, monitored the Foley negotiations and closing, approved all the Foley/Blair documents and set April 3, 1970 as a deadline for the consummation of that transaction. In addition, the Stock Exchange maintained an examiner at Blair at all times: he was given access to all Blair's financial data. Blair came to the Stock Exchange for guidance—and the Stock Exchange very liberally gave it. The Amex had the same power and was aware of the same difficulties at Blair, yet left all direction to the Stock Exchange. The Amex's failure to fully exercise its powers does not change its status. Beyond question, both exchanges, particularly the New York Stock Exchange, were controlling persons.

Under the 1934 Act, a controlling person may not avoid liability unless he can affirmatively establish that he had

no knowledge of or reason to believe the existence of the fraud committed by the controlled person. Under the 1933 Act, only where the controlling person has "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action" may liability to the controlling person be avoided. In the present circumstances, both exchanges knew of the wrongs alleged: in the case of the Stock Exchange, it directed Blair in their commission and made them possible.

In *Hughes* v. *Dempsey-Tegeler & Co., Inc.* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. Sept. 1973), *aff'd on other grounds, Hughes* v. *Dempsey-Tegeler & Co., Inc.,* 534 F.2d 156 (9th Cir. 1976), the New York Stock Exchange was held to be a controlling person because of its direct participation in the solicitation of a subordinated loan. Recently, in *Carr* v. *New York Stock Exchange,* No. C-73-0367 SW (N.D. Cal. May 3, 1976), the District Court declined to impose "controlling person" liability on the Stock Exchange for improper regulation by the Stock Exchange. The facts in this case do not involve mere improper regulation. They involve direct Stock Exchange participation in the inducement of appellants' subordination and each of the facts surrounding the fraud perpetrated upon appellents.

In *Hecht* v. *Harris, Upham & Co.,* 283 F.Supp. 417 (N.D. Cal. 1968), *aff'd,* 430 F.2d 1202 (9th Cir. 1970), the Court defined the meaning of "good faith" as a defense. It declared (283 F. Supp. at 438):

> ". . . to satisfy the requirement of good faith it is necessary to show that precautionary measures were taken to prevent the violation . . ."

See also, *Demarco* v. *Edens,* 390 F.2d 836, 841 (2d Cir. 1968). It is abundantly clear neither exchange undertook any steps necessary to prevent the fraud perpetrated upon appellants. The Stock Exchange directed Blair to draw

in their capital. As senior stock Coordinator Deignan testified:

> "Q. Isn't it a fact, Mr. Deignan, that the Exchange wanted Foley's money in Blair?
>
> A. Well, not as such. We certainly wanted money in the firm. We didn't particularly care whose it was.
>
> Q. As a matter of fact, you didn't care whose it was?
>
> A. That's right.
>
> Q. You weren't particularly interested in Foley, just as long as you could get money in, as much as you could?
>
> A. Yes." (A 721-22)

It was the Stock Exchange's direction to Blair that it seek out additional capital after Blair informed the Stock Exchange that it was "out of control". It was the Stock Exchange's decision to send examiners into Blair to go over Blair's financial condition and make their own findings and it was a Stock Exchange examiner who was at Blair on a full time basis from late 1969 or early 1970 onward. It was the Stock Exchange's decision on February 19, 1970 to direct Blair to get an additional $2,000,000 in securities immediately. It was the Stock Exchange's decision to delay the imposition of corrective sanctions because of a "60 day loan" by Blair director Melville H. Ireland. It was the Stock Exchange which set April 3, 1970 as the final date for appellants to close and Blair to bring itself into compliance. It was the Stock Exchange that knew Blair was not in compliance even with the inclusion of appellants' securities, yet allowed the closing to be completed. It was the Stock Exchange's decision to commence the liquidation of the insider subordinated securities on April 6, 1970 and thereby immediately nullify the withdrawal provisions of the Foley loan agreement. It was the Stock Exchange which allowed Blair to be liquidated instead of merged with Thomson & McKinnon because of an exposure of $750,000 to its Special Trust Fund.

Significantly, all Stock Exchange directions that Blair close with appellants came at a time when Blair's financial condition was completely out of control. And despite all its knowledge and direction of Blair, the Stock Exchange sought only to insulate itself from liability by extracting a "knowledgeability letter" from Dr. Foley at the closing —a document which was subsequently described by the Stock Exchange as "confusing". And, a document which, as a matter of law, is null and void. As the Court declared in *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, Current Fed. Sec. L. Rep. ¶ 95,513 at 99, 619, n. 13:

> "We emphasize that our conclusion that Hughes has waived his right to recover is not influenced by his signing a so-called 'knowledgability letter' directed to the Exchange. The letter stated that Hughes had investigated the desireability of the subordination agreement, that he was familiar with the restrictions imposed on Dempsey, and that he agreed that the Exchange would not be liable to him with respect to his subordination loan. Regardless of the applicability of the letter to the breach found in this case, any waiver included in such a letter would be rendered void by Section 29 of the Securities Exchange Act, 15 U.S.C. § 78cc. We find Hughes to have waived any right to recover not from what he signed, but from what he knew and from what he did."

Thus, it is submitted that the conduct of the Stock Exchange in directing the solicitation of appellants' subordination at a time it knew that Blair was "out of control", deteriorating and had no actual figures to rely on and then extracting a knowledgeability letter at the time of closing which made no mention of the scope of Blair's problems establishes its status as a controlling person under Section 16 and Section 20(a) in the fraud perpetrated upon appellants. In the case of the Amex, the refusal of the Amex to act when it knew of Blair's problems

and had the duty to act, places upon it the status of a controlling person.

It is urged that the District Court erred in directing a verdict on the basis of the foregoing and holding, as a matter of law, that the Exchanges acted in "good faith". In view of all of the evidence and the inferences to be drawn therefrom, it is submitted that reasonable men could have differed as to whether the Exchanges fulfilled their obligation as controlling persons.

POINT III

The Exchanges violated Section 6 of the 1934 Act.

At the conclusion of appellants' case, the court below dismissed their action against the American Stock Exchange on the issue of § 6 liability. The issue of the New York Stock Exchange's liability under § 6 was submitted to the jury and the jury rendered a verdict in favor of appellee.

Appellants contend that the court erred in dismissing the claims against the American Stock Exchange. In addition, the court committed numerous prejudicial errors with respect to rulings during the trial and improperly charged the jury with respect to the New York Stock Exchange's potential liability under § 6. For example, the court improperly charged that the Stock Exchange was not a guarantor or insurer despite the fact that appellants never contended such fact, and that the knowledgeability letter was evidence that appellants had complete knowledge of the financial condition of Blair. Moreover, the court denied appellants' motion for a new trial without a hearing even though appellants had demonstrated that the jury had been tampered with.

However, in view of this court's recent decision in *Arneil* v. *Ramsey*, —— F.2d —— (1977), holding that a subordinated lender does not have standing to sue under § 6, appellants only raise but do not argue these points of law.

CONCLUSION

The judgments below should be reversed and a new trial ordered on the issue of federal securities law violations.

Respectfully submitted,

Hawkins, Delafield & Wood
Attorneys for Plaintiffs-Appellants

Clarence Fried
Robert R. MacDonnell
Samuel Turetsky
James O'Connor
Of Counsel

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

J. P. FOLEY & COMPANY, INC.,
JOHN P. FOLEY, JR., ANNE A.
FOLEY, and ANITA SALISBURY,

Plaintiffs-Appellants,

against

NEW YORK STOCK EXCHANGE, and
AMERICAN STOCK EXCHANGE,

Defendants-Appellees.

State of New York,
County of New York,
City of New York—ss.:

IRVING LIGHTMAN, being duly sworn, deposes and says that he is over the age of 18 years. That on the 7th day of April, 1977, he served two copies of Brief for Plaintiffs-Appellants on Milbank, Tweed, Hadley & McCloy, Esqs. and Lord, Day & Lord, Esqs., the attorneys for Appellees New York Stock Exchange and American Stock Exchange, respectively by delivering to and leaving same with a proper person in charge of their offices at One Chase Manhattan Plaza 25 Broadway, respectively in the Borough of Manhattan, City of New York, between the usual business hours of said day.

Irving Lightman

Sworn to before me this

7th day of April, 1977.

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 31-5472920
Qualified in New York County
Commission Expires March 30, 1978